EXHIBIT G

AICPA Audit and Accounting Guide: Investment Companies

PREPARED BY THE INVESTMENT COMPANIES SPECIAL COMMITTEE

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Notice to Readers

This AICPA Audit and Accounting Guide has been prepared by the AICPA Investment Companies Guide Task Force to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist auditors in auditing and reporting on such financial statements in accordance with generally accepted auditing standards (GAAS).

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1 AU sec. 411), identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board (FASB) as sources of accounting principles in category *b* of the hierarchy of GAAP that it establishes. This Audit and Accounting Guide has been cleared by FASB.

AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203), of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the accounting guidance in this guide, as discussed in paragraph .07 of AU section 411. fn *

operating effectiveness may provide a basis for assessing control risk below the maximum, it does not permit the auditor to assess the level of control risk so low as to eliminate the need to perform substantive tests for the fund's capital accounts and transactions.

4.59 Paragraph .18 of AU section 324 provides guidance on the auditor's considerations in using a service auditor's report. The auditor may wish to discuss with the service auditor the scope and results of the service auditor's work for a better understanding of the procedures and conclusions.

4.60 Paragraph .21 of AU section 324 states the auditor should not refer to the report of the service auditor as a basis, in part, for an opinion on the fund's financial statements. The service auditor's report is used in the audit, but the service auditor is not responsible for examining any portion of the financial statements as of any specific date or for any specific period.

Chapter 5

Complex Capital Structures

5.01 Many investment companies adopt complex capital structures to increase flexibility in pricing and access to alternative distribution channels for their shares. Such structures are principally of two kinds: multiple-class funds and master-feeder funds. In addition, many organizations are offering funds of funds, which are discussed later in this chapter.

5.02 Multiple-class funds issue more than one class of shares. Each class of shares typically has a different kind of sales charge, such as a front-end load, contingent-deferred sales load, 12b-1 fee, or combinations thereof. Multiple-class funds may charge different classes of shares for specific or incremental expenses, such as transfer-agent, registration, and printing expenses related to each class.

5.03 A commonly used multiple-class structure includes (but is not limited to) the following classes of shares:

- *Class A.* Class A shares are charged primarily a front-end sales load. (The shares might also be assessed a low 12b-1 or service fee.)
- *Class B.* Class B shares bear a contingent deferred sales charge (CDSC) coupled with a 12b-1 distribution or service fee. Class B shares often convert to Class A shares at a specified future date so as to avoid being assessed a higher 12b-1 fee for an extended period.
- *Class C.* Class C shares bear a level sales load, typically a 12b-1 distribution or service fee similar to the level charged in Class B. Class C shares usually have a 1 percent CDSC assessed for one year. There is usually no conversion to another class.

- *Institutional shares.* Shares typically bear no sales load and usually do not have 12b-1 distribution charges. There may be a service fee depending upon the source of the shares, whether they are sold through wrap programs or trust departments. Such selling agents often have their own structures that charge the fee directly to the investor.

5.04 Although no legal requirements exist regarding specific class designations, many in the industry have adopted the previously mentioned nomenclature voluntarily to avoid shareholder and sales force confusion.

5.05 In master-feeder structures, separate investment companies often perform the investment management and distribution functions. Feeder investment companies, each having similar investment objectives but different distribution channels for their shares (such as retail or institutional customers), invest their assets solely in another investment company, known as the master fund. All investment management functions are conducted by a master fund, whereas distribution, shareholder-servicing, and transfer agent functions are conducted by the feeders.

5.06 The master fund is generally organized as a trust, with attributes that qualify it as a partnership for tax purposes, and may be registered under the Investment Company Act of 1940. Feeders are generally organized as corporations or trusts, may be taxed under the Internal Revenue Code (IRC) as regulated investment companies (RICs), and may be registered as investment companies under the Investment Company Act of 1940 and the Securities Act of 1933 (and the Securities Exchange Act of 1934, as appropriate). A feeder fund also may be organized with a multiple-class structure. A feeder fund may also be organized under a different legal structure if it is not a registered product and is being used as a vehicle for nonpublic investing. If the master fund is organized outside the United States, it may serve as an investment vehicle for both offshore feeder funds sold solely to foreign investors and to domestic feeder funds sold solely to U.S. investors.

Operational and Accounting Issues

5.07 In 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. (FIN) 46, *Consolidation of Variable Interest Entities*, an interpretation of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, and FIN 46(R), *Consolidation of Variable Interest Entities (revised December 2003)*, which replaced FIN 46. Until the issuance of FIN 46, investment companies generally only consolidated controlling voting interests in other investment companies or entities that provide services to the investment company. FIN 46 and FIN 46(R) changed the model for determining when to consolidate a controlling financial interest by requiring a variable interest entity (VIE) to be consolidated when the investment company is subject to a majority of the risk of loss from the VIE's activities or is entitled to receive a majority of the entity's residual returns, or both. Those interpretations also require disclosures about VIEs that the investment company is not required to consolidate but in which it has a significant variable interest. Registered investment companies are not required to consolidate a VIE unless the VIE is a registered investment

company. fn *

Multiple-Class Funds

5.08 Multiple-class funds have unique operational and accounting issues. These issues include the methods and procedures (*a*) to allocate income, expenses, and gains or losses to the various classes to determine the net asset value per share for each class; (*b*) to calculate dividends and distributions to shareholders for each class; and (*c*) to calculate investment performance for each class (such as total return and Securities and Exchange Commission [SEC] yield).

5.09 Rule 18f-3 under the Investment Company Act of 1940 establishes a framework for an open-end fund's issuance of multiple classes of shares representing interests in the same portfolio. Before the adoption of the rule, funds were required to obtain an exemptive order from the SEC to initiate a multiple-class structure. The rule permits certain differences in expenses between classes and prescribes how income, expenses, and realized and unrealized gains and losses may be allocated among the classes. Funds operating under existing multiple-class exemptive orders may elect either to adopt the rule or to continue to follow all of the terms and conditions set forth in their exemptive order.

5.10 To calculate the net asset value per share of each class for multiple-class funds, income, expenses, and realized and unrealized gains or losses must be allocated to each class. Fees and expenses of the fund need to be classified as either fund or class-level expenses. Fund-level expenses, such as investment management fees, apply to all classes. Rule 18f-3 identifies certain expenses, such as distribution and servicing fees, as being class-level expenses and requires that they be generally charged directly to the individual classes to which they relate. Under the rule, other expenses, such as transfer-agent and registration fees attributable to individual classes, may be designated as class-level expenses at the discretion of the fund's board of directors or remain fund-level expenses. All other expenses are allocated among the classes based on a methodology discussed in paragraph 5.12. Rule 18f-3 provides for the exercise of judgment by the fund and its directors as to the appropriateness and fairness of the expense allocation methodology. Because certain expenses are charged to the classes of shares differently, net asset value per share and dividends per share must be calculated separately for each class of shares. Class B shareholders will normally receive a smaller dividend per share from net investment income than Class A shareholders because of higher distribution and servicing fees. Net asset value per share may differ among classes.

5.11 Each class of shares bears all its identified class-specific expenses. The IRS currently takes the position that funds with multiple classes have only one class of shares for tax purposes. Revenue Procedure 96-47 essentially provides that if a fund pays dividends of differing amounts (differential dividends) to its various classes of shares pursuant to a capital structure allowed by (or similar to that allowed by) rule 18f-3, the IRS will not consider such dividends to be preferential. This revenue procedure allows differential dividends due to divergent charges for items such as 12b-1 fees, shareholder servicing fees, and any other

class-specific expenses. Fund-level expenses, such as management fees, custodian fees, and other expenses related to the management of the company's assets, must be allocated proportionally among all classes using an allocation methodology discussed in paragraph 5.13.

5.12 Class-specific expenses may be waived or reimbursed at different amounts for individual classes. However, rule 18f-3 requires a fund's board of directors to monitor waivers or reimbursements to guard against cross-subsidization among the classes. Fund management must also ensure that such waivers or reimbursements do not create a preferential dividend to a particular class of shares from a tax perspective. Revenue Procedure 99-40 covers circumstances under which such expenses may be reimbursed for tax purposes. To protect itself from an inadvertent preferential dividend, a rigorous approach to the documentation of class expense differences (including waivers or reimbursements), and also compliance with any private letter rulings, should be followed carefully by multiple-class funds. See paragraphs 6.62–.63 for more specific guidance regarding preferential dividends.

5.13 The methods for allocating income, fund-level expenses, and realized and unrealized gains or losses set forth in rule 18f-3 are as follows:

- *Fair value of shares outstanding—relative net assets.* Under this method, each class of shares participates based on the total net asset value of its shares in proportion to the total net assets of the fund. Under rule 18f-3, it is expected that this method will be the primary method used to allocate income, fund-level expenses, and realized and unrealized gains and losses for calculating the net asset value of nondaily dividend funds.

- *Fair value of settled shares outstanding.* Under this method, earnings are allocated based on the fair value of settled shares. It is typically used to achieve consistency between the allocation method and a fund's dividend policy with respect to the shares eligible to receive dividends. For example, most daily dividend funds pay dividends only to settled shares and, therefore, in a fund that requires settlement of its shares on a trade-date-plus-three basis, the appropriate basis of allocation of income and nonclass-specific expenses would be the fair value of settled shares. Rule 18f-3 permits daily dividend funds to use the settled-shares method for allocating income and expenses and the relative-net-assets method for allocating realized and unrealized gains and losses.

- *Shares outstanding.* This method provides for each share outstanding to participate equally in the nonclass-specific items of income, expense, gains, and losses. Under rule 18f-3, this method may be used by funds provided (*a*) that the fund is a daily dividend fund that maintains the same net asset value per share in each class, (*b*) that the fund has agreements in place for waivers or reimbursements of expenses to ensure that all classes maintain the same per share net asset value, and (*c*) that payments waived or reimbursed under such agreements may not be carried forward or

recouped at a future date.

- *Simultaneous equations.* This method ensures that the annualized rate of return of each class will differ from that of the other classes only by the expense differential among the classes.

- *Any appropriate method.* A fund may use any appropriate allocation method so long as a majority of the fund's directors, including a majority of the directors who are not interested persons of the fund, determines that the method is fair to the shareholders of each class and that the annualized rate of return of each class will generally differ from that of the other classes only by the expense differentials among the classes.

Whichever method is selected, rule 18f-3 requires the fund to use that method consistently. Illustrations using the allocation methods discussed previously are presented in exhibit 5-1.

5.14 Rule 18f-3 does not specify any requirements regarding the distribution calculation methods that a multiple-class fund generally should use. The methods generally used to calculate distributions to shareholders from net investment income are as follows:

- *Record share method.* The sum of net investment income available for all classes after deducting allocated expenses, but before consideration of class-specific expenses, is divided by the total outstanding shares on the dividend record date for all classes to arrive at a gross dividend rate for all shares. From this gross rate, an amount per share for each class (the amount of incremental expenses accrued during the period divided by the record date shares outstanding for the class) is subtracted. The result is the per share dividend available for each class.

- *Actual income available method.* Actual net investment income that has been allocated to each class (as recorded on the books) is divided by the record date shares for each class to derive the dividend payable per share.

- *Simultaneous equations method.* This method seeks to ensure, by using simultaneous equations, that the distribution rates will differ among the classes by the anticipated differential in expense ratios.

5.15 The record share method is most commonly used by funds that do not pay dividends daily (nondaily dividend funds). It is also used by daily dividend funds that employ policies to manage their dividend payout levels (such as to distribute stable dividend amounts or to compensate for book-tax differences). The dividend payout level may be managed for only one share class; the dividend rates for the other classes will vary because class-level expenses differ between classes. The record share method is simple to apply, provides assurance that the annualized distribution rate for the class with higher expenses will be lower than that for the class with lower expenses, and minimizes the likelihood of a preferential dividend being paid. The disadvantage of this method is that the annualized distribution

rates of the various classes usually will not reflect the precise expense ratio difference between the classes, because the directly related expenses accrued over time on a varying number of shares are reduced to a per share amount on the record date shares. The larger the fluctuation in shares over time, the greater the potential difference.

5.16 The actual income available method is used for funds that declare daily dividends per share equal to the amount of net investment income allocated to each class. This results in the same per share net asset value for all classes (except for differences that may result from rounding). The actual income available method is not typically used for funds that pay dividends on a periodic basis.

5.17 The simultaneous equations method is used for periodic dividend funds and is more complex than other methods. This method ensures that the annualized distribution rates will differ among classes by the approximate amount of the expense ratio difference. Per share net asset value will usually converge after the dividend has been recorded.

5.18 Because distribution amounts under both the record-share and the simultaneous equations methods are determined independently of the amount of net investment income allocated to each class, situations can result whereby, after recording the dividends, one class has positive undistributed income while the other class is negative. For financial reporting purposes, a return of capital is not determined at the class level and distributable earnings is disclosed only at the fund level.

5.19 To avoid paying a preferential dividend for tax purposes, multiple-class funds ordinarily should declare long-term capital gain distributions at the fund level rather than at the class level, so that all shares receive the same per share gain distribution. This is so regardless of the frequency of income dividends or the distribution calculation method selected. Illustrations of the previously mentioned distribution calculation methods are presented in exhibit 5-2.

Master-Feeder Funds

5.20 Master-feeder sponsors sometimes apply to the IRS for a private letter ruling to ensure that the master will be treated as a partnership for federal income tax purposes and that each feeder will be treated as an owner of its proportionate share of the earnings and profits and net assets of the master. This is to make sure that the feeders maintain their status as regulated investment companies and can afford their shareholders the pass-through tax benefits that result from that status.

5.21 Master-feeder accounting involves allocating the master portfolio's income, expenses, and realized and unrealized gains and losses among its feeder funds. Because most master funds are typically structured as partnerships for tax purposes, the allocation of income, expenses, gains, and losses follows partnership tax allocation rules (partner's distributive share rules as provided for in section 704(b) of the IRC). According to the IRC, each feeder must be allocated its share of gain or loss realized by the master when the master disposes of a particular security lot. The tax allocation process is complicated because the relative interest of the feeder funds in the master portfolio changes, usually daily, as feeder fund shares are sold or redeemed. Before final regulations that apply

after December 21, 1993, the IRC required this allocation to follow the literal partnership allocation methodology that implies a "property-by-property" method for investment partnerships. Performing tax allocations under the property-by-property method requires evaluating each feeder's share of the realized gain or loss on the security lot sold. The final regulations allow allocation based on an aggregate method. In the absence of a ruling from the IRS, the regulation allowing an "aggregate method" for allocating gains and losses does not apply to built-in gains and losses from securities contributed by a feeder to a master in a nontaxable event. However, certain "qualified" master feeders that meet the requirements of revenue procedure 2001-36; are permitted to use the aggregate method for contributed property; although other fund groups would still require a private letter ruling from the IRS. Performing tax allocation under the aggregate method requires evaluating each feeder's share of the unrealized gains or losses on its entire (that is, aggregate) interest in the master, rather than each feeder's share of the realized gain or loss on the sold security lot alone.

Funds of Funds

5.22 Funds of funds are investment companies that invest in other investment companies. Funds of funds have been popular in the investment partnership market and have recently become more popular in the registered fund market. Master-feeder structures can be viewed as funds of funds. but usually only with one top-tier (portfolio) fund; a more typical fund of funds structure has more than one top-tier fund. Historically, a registered investment company's ability to invest in other investment companies was limited by section 12(d) of the Investment Company Act of 1940. Under section 12(d), fn † an open-end investment company is limited, among other restrictions, to aggregate investments in other investment companies of 10 percent of the acquiring company's total assets. Master-feeder structures, however, are specifically permitted by section 12(d)-(I)(E)(ii) of the Investment Company Act of 1940. As a result, except for a limited number of registered funds that received exemptive orders from the SEC, fund of funds structures have been limited to unregistered investment companies. In 1996, section 12(d) was amended to permit registered investment companies to invest in other investment companies provided that both the investor and investee funds were part of the same group of investment companies (affiliated funds). Investments in nonaffiliated funds would continue to be subject to the historical limitations under section 12(d) unless an exemptive order is obtained from the SEC. fn ‡

5.23 Many multitiered structures are U.S. domiciled, but recent trends include the creation of offshore, domestic, and blended structures. A blended structure might include a fund with significant investments in other investment companies and also investments in individual securities. Participants in such structures include both foreign and domestic investors, individually and through funds, commodity pools, retirement accounts, and other sources.

5.24 For publicly-traded investee funds, market quotes are usually available. For those investee funds that are not publicly traded, market quotes may not be readily available. In such instances, the fair value of investments in investee funds, as

determined by the investor fund's board of directors or management, generally should be used to value the investments on the books of the investor fund. Fair value may be determined by reference to the investor fund's interest in the investee fund's net assets. The valuation of an investee fund by the investor generally should reflect any incentive or performance fee or incentive allocation of earnings to the general partner based on the current performance of the investee fund.

Other Considerations for Investments in Nonpublicly Traded Investees

5.25 Proper execution of the fund of funds strategy ordinarily requires management of the investor fund to exercise significant judgment in selecting and monitoring the performance of the investee funds. Occasionally, management may engage an outside consultant to assist in the performance monitoring and selection process. Because this process may include many procedures, a review of prior audited financial results generally should be included.

5.26 Monitoring the performance is an essential control in the operation of the fund. Fund management ordinarily should review regular (for example quarterly) investment results and periodically review the trading strategy being followed by the investee company to make sure that it is consistent with the strategy approved at the time of the initial investment. The results of daily monitoring functions established by management of the investee company generally should also be reviewed periodically. Discussions with each investee company to identify any significant changes or problems with systems, illiquid securities, personnel, or trading strategies generally should be held periodically and documented. At times, such as when there are significant changes in market conditions or a particularly risky strategy, monthly or more frequent discussions may be advisable. Another essential control that management of the investor fund normally should exercise is comparison of preliminary annual results reported by the investee fund to the investee fund's audited financial statements. The audited financial statements should substantiate the reliability of the investee fund's reporting processes.

5.27 As an additional control over the valuation process, management of the investor fund may wait for receipt of audited financial statements and individual capital account statements from investee funds to make sure no significant changes in previously reported results have occurred before the investor fund issues its audited financial statements. This approach provides key audit evidence and instills discipline into the investor fund's financial reporting system.

Financial Statement Presentation

5.28 In addition to the financial statement reporting requirements in chapter 7, management investment companies that have multiple classes of shares or master-feeder structures follow reporting guidelines discussed in the following paragraphs when preparing financial statements, including financial highlights. Illustrations are presented at the end of this chapter.

Multiple-Class Funds

5.29 Refer to exhibit 5-3 for examples of each of the following three statements.

Statement of Assets and Liabilities. The composition of net assets is reported in total, but net asset value per share and shares outstanding generally should be reported for each class. The maximum public offering price per share is often reported for each class.

5.30 *Statement of Operations.* Class-specific expenses are reported for each class (or disclosed in the notes to the financial statements). Reporting the amount of fund-level expenses allocated to each class is not required. However, some funds voluntarily disclose fund-level expenses by class in the statement of operations or in notes to the financial statements.

5.31 *Statement of Changes in Net Assets.* Dividends and distributions paid to shareholders and capital share transactions for each class are required to be presented (or disclosed in the notes to the financial statements).

5.32 *Notes to Financial Statements.* The notes should

- describe each class of shares, including sales charges, shareholder servicing fees, and distribution fees.
- disclose the method used to allocate income and expenses, and realized and unrealized capital gains and losses, to each class.
- describe fee arrangements for class-specific distribution plans and for any other class-level expenses paid to affiliates.
- disclose capital share transactions (if not disclosed separately in the statement of changes in net assets) for each class.
- disclose total sales charges paid to any affiliates for each class.

5.33 *Financial Highlights.* Financial highlights, including total return, should be presented by class except for portfolio turnover, fn 1 which is calculated at the fund level. Because the financial highlights table is considered to be a financial statement disclosure and not a financial statement, the SEC has accepted the presentation of a financial highlights table only for a specific class or classes of shareholders for whom the financial statements are intended. The financial highlights for any class for which the shareholders are precluded from investing in may be omitted. In such situations, the auditor's report should be addressed to the fund board and the shareholders in the specific class or classes and not to all shareholders taken as a whole.

Master-Feeder Funds

5.34 Under current SEC policies, the annual and semiannual reports for feeder funds should contain two sets of financial statements, one for the master fund and the other for the specific feeder fund. (Refer to exhibits 5-4–5-5 for illustrative financial statements. Items to follow correspond to these exhibits.) When the master and feeder funds have different year ends, the SEC has indicated fn 2 that it would not object if, at each feeder investment company year end, the audited shareholder report of the feeder is accompanied by the latest audited shareholder

report of the master as well as an unaudited balance sheet and schedule of investments of the master as of the date of the feeder's financial statements.

5.35 *Statement of Assets and Liabilities*. Each *feeder fund's* statement of assets and liabilities shows an investment in the master fund, which is the sole or principal investment of the feeder fund. The total of all feeder funds' investments in the master fund should equal the total net assets of the master fund. A schedule of portfolio investments is not presented at the feeder level. The net asset value per share, total shares outstanding, and the components of net assets should be reported. Should the feeder fund have a multiple-class structure, it would report the multiple-class information specified in this chapter.

5.36 *Master funds* are usually organized as trusts with flow-through accounting treatment to their feeder funds. As such, the statement of assets and liabilities of the master fund usually does not report the components of net assets, shares outstanding, or net asset value per share.

5.37 The *portfolio of investments* is included only in the master fund's financial statements.

5.38 *Statement of Operations*. The statement of operations reports details of the *feeder fund's* allocated share of net investment income from the master fund (that is, separate disclosure of allocated interest, dividends, and expenses). The statement also reports separately the feeder's allocated share of the master fund's realized and unrealized gains and losses. The total of all feeders' income, expense, and realized and unrealized gain or loss components should agree to the corresponding totals of the master fund. Feeder funds should disclose their fund-specific expenses, such as transfer agent, distribution, legal and audit expenses, and registration and directors' fees. Additionally, any fee waivers or reimbursements at the feeder-fund level should be reported.

5.39 For *master funds*, the standard reporting format for investment companies with simple capital structures is used.

5.40 *Statement of Changes in Net Assets*. For *feeder funds*, the standard reporting format for investment companies with simple capital structures is used. If the feeder fund is a multiple-class fund, the guidance of paragraphs 5.28–.33 generally should be followed.

5.41 The statement of changes in net assets of a *master fund* generally should report capital transactions from or to feeder funds as contributions and withdrawals, respectively. Dividend distributions are normally not made by the master fund when the master fund is treated as a partnership for tax purposes. In those situations where the master fund is treated as a RIC and is taxed either as a corporation or trust, there may be distributions to the feeder funds to eliminate any accumulated taxable income at the master fund level.

5.42 *Notes to Financial Statements*. Notes to the financial statements of each *feeder fund* should include

- a general description of the master and feeder structure.

- the feeder's percentage ownership share of the particular master fund at the reporting date.

- a statement that the feeder invests all of its investable assets in a corresponding open-end management investment company having the same investment objectives as the feeder, and a reference to the financial statements of the master fund, including the portfolio of investments.

5.43 The notes should disclose or refer to the accounting policies of the master fund that affect the feeders (such as valuation of investments of the master fund). Information concerning the purchases and sales of investments and gross unrealized appreciation or depreciation of investments on a tax basis (required by Regulation S-X) is not applicable to the feeder's financial statements.

5.44 *Financial Highlights.* The feeder fund's ratios of expenses and net investment income to average net assets should include the expenses of both the feeder and the master fund. Balance credits earned by the master fund should be reflected in the feeder fund ratios as if they had been earned by the feeder fund directly. *Feeder funds* need not disclose a portfolio turnover rate because feeders invest all their assets in the master fund. However, to the extent the financial highlights table conforms to the instructions of Form N-1A, it should report the portfolio turnover rate experienced by the master. The financial highlights of feeder funds that are registered investment companies generally should comply with the same requirements as for registered investment companies not organized in a master-feeder structure (see paragraphs 7.76–.79).

5.45 The financial highlights section of the *master fund* organized as a partnership is substantially modified, because per share information is not applicable. The master fund financial highlights section should include the total return, ratios of expenses and net investment income to average net assets, and portfolio turnover rate. fn 3 Master funds not organized as partnerships generally should report normal per share data in the financial highlights section.

5.46 *Auditor's Report.* The auditor's report for the feeder fund is modified to exclude the phrase "including the portfolio of investments" because the portfolio of investments is not part of the feeder fund's financial statements.

Funds of Funds

5.47 *Example Financial Statements.* Exhibit 5-6 contains illustrations of relevant fund of funds financial statements. Items discussed in the following paragraphs refer to this exhibit.

5.48 *Statement of Assets and Liabilities.* The reporting fund may list the investee (portfolio) funds directly on the statement of assets and liabilities. Additional disclosures may be required for those funds that hold a mixture of investments in other investment companies and direct investments in securities. However, there is usually no need for a separate schedule of investments. For registered investment companies, investments in affiliated funds are considered investments in affiliates subject to Rule 12-14 of Regulation S-X. Such investments may not be reported using the summary portfolio schedules permitted under Regulation S-

X Rule 12-12C. (Refer to chapter 7 in this guide for further discussion of generally accepted accounting principles applicable for the preparation of financial statements of investment companies.)

5.49 Fund management generally should consider whether an investment in a single underlying fund is so significant to the fund of funds as to make the presentation of financial statements in a manner similar to a master-feeder fund (exhibits 5-4–5-5) more appropriate.

5.50 *Statement of Operations*. Income reflected on the statement of operations normally should represent the net earnings received from investee funds. For example, if the investee funds are all registered investment companies (as in the example in the exhibit), then the income would represent the dividends received from such investee funds. The investor fund may not reflect any operating expenses if the investee funds have agreed to assume certain of the investor fund expenses. To the extent the investor fund has such agreements, they should be disclosed in the notes.

5.51 When investing in registered investment companies, distributions received from long-term capital gains should be reported as realized gains together with gains realized on disposition of shares of investee companies.

5.52 Expenses are those incurred only at the reporting fund level. Expenses of the investee funds are embedded in the net earnings from such funds.

5.53 *Financial Highlights*. The financial highlights for the reporting fund in a fund-of-funds structure are usually similar to a standalone feeder fund in a master-feeder structure. Net investment income and expense ratios generally should be computed based upon the amounts reported in the statement of operations, and portfolio turnover ordinarily should be measured based on the turnover of investments made by the reporting fund in the investee funds, not looking through the investee funds to their portfolio activity.

5.54 *Notes to Financial Statements*. Fund management should consider whether, and to what extent, disclosure of the investee funds' investment policies is appropriate. Notes to the financial statements of the reporting fund should include

- a general description of the fund of funds structure.
- disclosure of valuation policy—values are generally based on information reported by investee funds.

Audit Consideration

5.55 Many master-feeder structures are capitalized by transferring the investments and related assets and liabilities of an existing fund to a newly organized master fund. In exchange for the assets transferred, the original fund becomes a feeder fund and receives a proportional ownership interest in the master fund. The auditor should be aware that management may obtain a private letter ruling from the IRS, or tax opinions from counsel in certain instances, to ensure treatment as a tax-free contribution. The auditor should also be familiar with the tax rules that may

require subsequent tracking and special allocation of the contributed unrealized gain or loss on the investments transferred to the master fund.

5.56 For multiple-class funds electing to continue to operate under the terms of their exemptive orders, the SEC requires an expert's opinion from the fund's auditors regarding the adequacy of the systems and internal controls to achieve the stated objectives included in the exemptive order request. The expert's opinion is required to be included each year in the fund's year-end Form N-SAR filing. The annual expert's opinion is not required for funds operating under rule 18f-3, which permits adoption of a multiple-class structure without an exemptive order, subject to certain parameters. (See the preface for information about the requirements of the Sarbanes-Oxley Act of 2002, related SEC regulations, and the standards of the Public Company Accounting Oversight Board for issuers and for auditors of issuers.)

5.57 *Multiple-Class Funds.* In connection with the audit of multiple-class funds, auditors should consider whether

- class-level and fund-level expenses have been determined as required by rule 18f-3 or as specified in the fund's SEC exemptive order.
- income, expenses, and realized and unrealized gains or losses have been allocated among the classes of shares in accordance with the allocation methods in rule 18f-3 or in the fund's SEC exemptive order.
- IRS regulations have been considered regarding the maintenance of class-level expense differentials necessary to avoid preferential dividends for income tax purposes.
- differences between expense and net investment income ratios of various share classes appear reasonable when compared with the amount or percentage differences in class-level expenses.

5.58 *Master-Feeder Funds.* In connection with the audit of master-feeder funds, auditors should consider whether

- fees and expenses incurred by the master fund or feeder funds are in accordance with contractual agreements as disclosed in the registration statement. Advisory and custodian fees are normally incurred only at the master fund; fees and expenses relating to distribution and shareholder servicing are normally incurred at the feeder level.
- controls and procedures are adequate to ensure that investment valuation and related income components are allocated properly to feeder funds.
- systems and controls are adequate to record accurately and timely the daily contributions and withdrawals between the feeder funds and the master fund. This is important to determine properly each feeder fund's proportionate ownership interest for purposes of computing daily

allocations. All shareholder purchases and redemptions are recorded at the feeder level. Assuming that cash is transferred on the same day, after the total daily net sales or redemptions are known for each feeder, contributions and withdrawals in the master fund are recorded to reflect changes in the feeders' ownership interests (that is, a net redemption at the feeder level will result in a withdrawal from the master fund). All such transactions at the feeder level affect the investment in the master fund. At the master fund level, the cash movements flow through the partnership equity or net assets account.

- satisfaction has been obtained as to the accuracy of master fund tax adjustments allocated to the feeder funds.

5.59 A master-feeder structure could consist of a master fund and feeder funds that are not related to each other, except that they are each feeders of the same master fund. Each feeder could have a different auditor who may also differ from the auditor of the master fund. It is also possible that the master and feeder funds could have different year ends. In connection with the audit of feeder funds having different auditors or year ends from those of the master fund, the following audit considerations should be taken into account.

Planning

5.60 The feeder fund auditor should discuss with the master fund's independent auditor the results of the most recent audit of the master fund.

5.61 The feeder fund auditor should inquire of feeder fund and master fund management as to any changes in fee structures, affiliated transactions, significant contingencies, results of regulatory reviews, or proposed transactions since the previous feeder fund and master fund audits. Consideration should be given to the implications of such changes on the nature, scope, and timing of audit testing and feeder fund financial statement presentation and disclosure.

5.62 Timing and logistics considerations will make planning and coordination among the management and auditors of the master and feeder funds necessary.

Control Environment

5.63 Feeder fund auditors should obtain sufficient knowledge of the control environment to understand the attitudes, awareness, and actions of those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting. Auditors must also consider the guidance in paragraph 5.49. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), must also be considered.

5.64 Paragraph .08 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), states that although much of the information the auditor obtains by inquiries can be obtained from management and those responsible for financial reporting, inquiries of others within the entity, such as production and internal audit personnel, and other employees with different levels of authority,

may be useful in providing the auditor with a different perspective in identifying risks of material misstatement. The feeder fund auditor also may review the master fund auditor's audit documentation related to the evaluation and testing of the master fund's control environment.

5.65 Paragraph .11 of AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), states the auditor uses his or her understanding of internal control to assess control risk for the assertions embodied in the account balances and classes of transactions, including those that are affected by the activities of the service organization. In doing so, the user auditor may identify certain user organization controls that, if effective, would permit the user auditor to assess control risk as low or moderate for particular assertions. Such controls may be applied at either the user organization or the service organization. The feeder fund auditor should consider the control and monitoring procedures performed by the feeder fund's management over its investment in the master fund. Tests of these control procedures could also be considered.

5.66 Inquiries should be made of the master fund's management and auditors with respect to changes or issues in the control environment since the last fiscal year end of the master fund or since the performance of the most recent tests of controls.

5.67 Based upon the results of the feeder fund auditor's evaluation of the control environment at the master fund, the feeder fund auditor should consider requesting the master fund auditor to perform, or directly perform, additional tests of controls.

Investment in Master Fund and Income-Gain Allocations

5.68 The auditor should obtain, as of the date of the feeder fund's financial statements, an understanding of the nature of securities held by the master fund and the procedures used to value these securities. Consideration should be given to requesting the master fund auditor to perform, or directly perform, additional procedures, particularly related to fair valued, fn 4 illiquid, or difficult-to-price securities. This may be particularly relevant if the feeder fund has a different year end from the master fund.

5.69 The auditor should consider requesting the master fund auditor to review the master fund's reconciliation of portfolio securities with the custodian bank and brokers as of the date of the feeder fund's financial statements. Based upon the results of these procedures, the auditor might request the master fund auditor to confirm, or directly confirm, the existence of the master fund's investments in securities with the custodian and brokers as of the date of the feeder fund's financial statements.

5.70 The feeder fund auditor might review the master fund auditor's audit documentation related to valuation testing, existence testing, or both types of testing, as of the most recent master fund audit.

5.71 The auditor may obtain confirmation from master fund management, as of the date of the feeder fund financial statements, of: (*a*) the value of the feeder fund's

investment in the master fund; (*b*) the feeder fund's percentage ownership in the master fund; and (*c*) allocations of income or gain from the master fund to the feeder fund during the period under audit.

Other Transactions

5.72 Through discussions with feeder fund and master fund management and review of accounting records, the auditor should consider whether significant transactions of the master fund have been accounted for properly and disclosed properly in the feeder fund's financial statements.

Prospectus Restrictions and Compliance

5.73 The auditor should consider making inquiries of master fund management with respect to the results of investment restrictions compliance monitoring, including any detected compliance violations and related resolutions during the period of the feeder fund financial statements.

5.74 The auditor should consider requesting the master fund auditor to review, or directly reviewing, the analyses and documentation with respect to the master fund's investment restrictions compliance.

5.75 The feeder fund auditor may review related master fund auditor's audit documentation. The feeder fund auditor might request the master fund auditor to perform, or directly performing, additional tests based upon the results and timing of such inquiries.

5.76 Paragraph .01 of AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), establishes a requirement that the independent auditor obtain written representations from management as a part of an audit of financial statements performed in accordance with generally accepted auditing standards and provides guidance concerning the representations to be obtained. Consideration should be given to obtaining representations related to investment compliance from master fund management.

Tax Qualifications and Compliance

5.77 The auditor may review analyses and documentation with respect to the master fund's tax compliance. Any tests of compliance with diversification requirements need to be met for both the master's as well as the feeder's fiscal periods.

5.78 The auditor might test feeder fund tax compliance (for example, sufficiency of distributions) for the period of the financial statements.

5.79 The auditor might review related master fund auditor's audit documentation.

5.80 The auditor might obtain tax-related representations from master fund management.

Financial Statements

5.81 The auditor should consider obtaining representations from feeder fund management that the financial statements reflect the value of the feeder fund's investment in the master fund.

5.82 The feeder fund auditor should read the most recent financial statements of the master fund.

5.83 Generally, when master and feeder funds share common reporting periods, the feeder fund's auditor's report should not be dated prior to the master fund's auditor's report.

Funds of Funds

5.84 Significant audit risks fn 5 may exist if management does not use strong procedural controls in selecting and monitoring a fund's investments in investee companies and determining the investments' fair value. The audit approach to an investor fund's investments in investee funds might focus on two areas:

a. Evaluating the investor and investee funds' control environments

b. Substantiating the fair value attributed to investments in investee funds fn 6

Control Environment

5.85 The primary concern in the control environment relates to the procedures that management of the investor fund uses to monitor its investments in investee funds. Investments in public investee funds may be valued based on reported daily net asset values, and the auditor may rely upon the structure established by the Investment Company Act of 1940 and Securities Act of 1933 to gain comfort that such reported fair values are accurate.

5.86 For investments in nonpublic investee companies, audit tests may include participation in management site visits or telephone calls to investee funds, or a review of documentation of such visits or calls. Prior experience with the investee funds' management, results of prior-year audits, or the history of adjustments to unaudited results reported by the investee funds, if any, should be considered in determining the extent to which such participation is necessary. For example, participation in management site visits would be more appropriate if the investee funds represented a significant investment by the investor fund or if serious concerns as to the management controls at the investee fund existed. The auditor should also review the investor fund's reconciliation of the unaudited financial results received from the investee funds to their audited financial statements for the prior year, if the current year's audited financial statements are not available. Any significant variations, their causes, and their effect on the investor fund's financial statements should be identified.

5.87 If significant variations are discovered in the comparison of prior-year audited financial statements with financial information obtained from the investee funds, the auditor should perform additional procedures such as participating in the management site visit, reviewing the investee fund's audited financial statements, or vouching withdrawals, if any, made from the investee fund after year end as part of the annual audit tests.

Exhibit 5-1

Methods of Allocating Income, Fund-Level Expenses, and Realized and Unrealized Gains (Losses)

	Total	*Class A*	*Class B*
Assumptions:			
Total shares outstanding		2,000,000	3,000,000
Settled shares outstanding		1,990,000	2,900,000
Net asset value per share		$10.52	$10.49
Fair Value of Shares Outstanding—Relative Net Assets:			
Total shares outstanding	5,000,000	2,000,000	3,000,000
Net asset value per share		$10.52	$10.49
Net asset value	$52,510,000	$21,040,000	$31,470,000
Allocation percentage		40.0686%	59.9314%
Fair Value of Settled Shares Outstanding:			
Settled shares outstanding	4,890,000	1,990,000	2,900,000
Net asset value per share		$10.52	$10.49
	$51,355,800	$20,934,800	$30,421,000
Allocation percentage		40.7642%	59.2358%
Shares Outstanding:			
Total shares outstanding	5,000,000	2,000,000	3,000,000
Allocation percentage		40.0%	60.0%

Exhibit 5-2

Methods of Computing Income Distributions Per Share

	Total	*Class A*	*Class B*
Assumptions:			
Net investment income before class specific expenses	$1,000,000		
Class-specific expenses:			
Class A		$13,000	
Class B			$59,000
Record date shares outstanding	5,000,000	2,000,000	3,000,000
Record Share Method			
Net investment income before class specific expenses	$1,000,000		
Total record date shares outstanding	5,000,000		
Gross dividend rate for all shares	$.2000	$.2000	$.2000
Per share class-specific expenses:			
Class A ($13,000/2,000,000)		(.0065)	
Class B ($59,000/3,000,000)			(.0197)
Per share dividend for each class		$.1935	$.1803
Actual Income Available Method			
Actual net investment income recorded on books of each class	$928,000	$417,600	$510,400
Record date shares outstanding for each class		2,000,000	3,000,000

Per share dividend for each class		$.2088	$.1701

Simultaneous Equations Method

EQUATION #1: A + B = $928,000

Where—A and B represent the total dividend amounts to be paid to each class.

EQUATION #2: A/2,000,000 - B/3,000,000 = (0.5% X $10.50)/4

Where

2,000,000 and 3,000,000 represent the record date shares of each class 0.5% represents the expense differential between Class A and Class B

$10.50 represents the average daily net asset value of the fund

4 refers to the fact that the dividend period is a quarter

Solving the previous simultaneous equations produces the following results:

	Total	*Class A*	*Class B*
Total dividends to be paid	$928,000	$386,961	$541,039
Record date shares outstanding for each class		2,000,000	3,000,000
Per share dividend for each class		$.1935	$.1803
Annualized distribution rates to average daily net asset value		7.37%	6.87%
Difference in distribution rates		0.50%	

Exhibit 5-3

XYZ Multiple-Class Fund
Statement of Assets and Liabilities
December 31, 20X4

Assets	
Investments in securities, at fair value, identified cost $18,674,000	$ 21,101,000
Cash	199,000
Deposits with brokers for securities sold short	1,555,000
Collateral for securities loaned, at fair value	620,000
Receivables:	
Dividends and interest	46,000
Investment securities sold	24,000
Capital stock sold	54,000
Other assets	26,000
Total assets	23,625,000
Liabilities	
Options written, at fair value (premiums received $110,000)	230,000
Securities sold short, at fair value (proceeds $1,555,000)	1,673,000
Demand loan payable to bank	2,000,000
Payable upon return of securities loaned	620,000
Due to broker—variation margin	10,000
Payables:	
Investment securities purchased	52,000
Capital stock reacquired	8,000
Other	4,000
Accrued expenses	8,000
Distribution payable	158,000
Total liabilities	4,763,000
Net assets	$ 18,862,000
Net assets consist of:	
Paid-in capital	$ 15,184,000
Distributable earnings	3,678,000

Total net assets	$ 18,862,000
Net asset value per share:	
Class A—based on net assets of $15,089,600 and 3,375,750 shares outstanding	$4.47
Class A public offering price ($4.47 net asset value divided by .95)	$4.71
Class B—based on net assets of $3,772,400 and 845,830 shares outstanding	$4.46

The accompanying notes are an integral part of these financial statements.

XYZ Multiple-Class Fund
Statement of Operations
Year Ended December 31, 20X4

Investment income:	
Dividends (net of foreign withholding taxes of $20,000)	$ 742,000
Interest	209,000
Income from loaned securities—net	50,000
Total income	1,001,000
Expenses:	
Investment advisory fee	137,400
Service fees—Class A	36,600
Distribution and service fees—Class B	37,000
Interest	10,000
Professional fees	18,000
Custodian	5,000
Transfer agent fees—Class A	10,000
Transfer agent fees—Class B	12,000
Directors' fees	10,000
Dividends on securities sold short	3,000
Total gross expenses	279,000
Less waivers:	
Distribution and service fees—Class B	(18,500)
Advisory fee	(34,500)
Total net expenses	226,000
Investment income—net	775,000
Realized and unrealized gain (loss) on investments:	
Net realized gain (loss) on investments	1,089,000
Net change in unrealized appreciation (depreciation) on investments	(1,649,000)
Net loss on investments	(560,000)
Net increase in net assets resulting from operations	$215,000

The accompanying notes are an integral part of these financial statements.

XYZ Multiple-Class Fund
Statements of Changes in Net Assets
Years Ended December 31, 20X4 and 20X3

	20X4	*20X3*
Increase (decrease) in net assets from operations:		
Investment income—net	$ 775,000	$ 724,000
Net realized gain on investments	1,089,000	1,000,000
Change in unrealized appreciation or	(1,649,000)	1,319,000

depreciation		
Net increase in net assets resulting from operations	215,000	3,043,000
Distributions to shareholders:		
Class A	(1,505,250)	(1,104,500)
Class B	(360,750)	(239,500)
Tax return of capital:		
Class A	—	(52,800)
Class B	—	(13,200)
Total distributions	(1,866,000)	(1,410,000)
Net increase from capital share transactions	2,721,000	4,700,000
Total increase in net assets	1,070,000	6,333,000
Net assets:		
Beginning of year	17,792,000	11,459,000
End of year	$18,862,000	$17,792,000

The accompanying notes are an integral part of these financial statements.

XYZ Multiple-Class Fund
Notes to Financial Statements

[The following notes are limited to illustrations of disclosures unique to a multiple-class fund structure. In addition to the disclosures provided, notes for a multiple-class fund would include all standard disclosures presented as part of the illustrative financial statements in chapter 7.]

1. Significant Accounting Policies

XYZ Multiple-Class Fund (the fund) is registered under the Investment Company Act of 1940 as a diversified, open-end management investment company. The fund offers 2 classes of shares (class A and class B). Each class of shares has equal rights as to earnings and assets except that each class bears different distribution, shareholder service, and transfer agent expenses. Each class of shares has exclusive voting rights with respect to matters that affect just that class. Income, expenses (other than expenses attributable to a specific class), and realized and unrealized gains or losses on investments are allocated to each class of shares based on its relative net assets. Class B shares automatically convert to class A shares at the end of the month following the eighth anniversary of issuance.

2. Capital Share Transactions

The fund is authorized to issue an unlimited number of shares in an unlimited number of classes.

Transactions in the capital shares of the fund were as follows:

	20X4		20X3	
	Shares	*Amount*	*Shares*	*Amount*
Class A:				

Shares sold	309,000	$1,444,500	690,500	$3,176,000
Shares issued from reinvestments	195,000	1,040,000	171,000	770,000
Shares redeemed	(57,000)	(253,500)	(40,000)	(186,000)
Net increase from capital share transactions	447,000	$2,231,000	821,500	$3,760,000
Class B:				
Shares sold	61,925	$290,100	185,000	$848,000
Shares issued from reinvestments	57,875	270,000	35,000	160,000
Shares redeemed	(15,000)	(70,100)	(15,000)	(68,000)
Net increase from capital share transactions	104,800	$490,000	205,000	$940,000

3. Investment Advisory Fees and Other Transactions With Affiliates

The fund has entered into a distribution plan, pursuant to rule 12b-1 under the Investment Company Act of 1940, with XYZ Distributors (distributors). Under the plan, class A shares pay a monthly shareholder servicing fee at an annual rate of 0.25 percent of class A average daily net assets. Class B shares pay monthly shareholder servicing and distribution fees at the annual rate of 0.25 percent and 0.75 percent, respectively, of class B average daily net assets. These fees compensate distributors for the services it provides and for expenses borne by distributors under the agreement. During the year ended December 31, 20X4, distributors waived $18,500 of its distribution fee related to class B shares.

For the year ended December 31, 20X4, distributors received $70,000 in sales commissions from the sale of class A shares. Distributors also received $6,500 of contingent deferred sales charges relating to redemptions of class B shares.

XYZ Service Company, an affiliate of advisers, provides transfer agent services to the fund. Under the transfer agent agreement with XYZ Service Company, the fund pays a monthly fee equal, on an annual basis, to $15 and $18 per shareholder account for class A and class B shares, respectively.

XYZ Multiple-Class Fund
Financial Highlights

		Class A			*Class B*	
	20X4	*20X3*	*20X2* fn		*20X4*	*20X3*	*20X2* fn	
Per share operating performance: fn #						
Net asset value, beginning of year	$ 4.88	$ 4.46	$ 4.00	$ 4.88	$ 4.45	$ 4.00
Income from investment operations:						
Net investment income	0.21	0.20	0.12	0.19	0.20	0.11
Net realized and unrealized gain (loss) on investment transactions	(0.12)	0.71	0.50	(0.12)	0.71	0.49
Total from investment operations	0.09	0.91	0.62	0.07	0.91	0.60
Less distributions:						
Dividends and distributions	(0.50)	(0.44)	(0.16)	(0.49)	(0.43)	(0.15)

Tax return of capital distributions	0	(0.05)	0	0	(0.05)	0
Total distributions	(0.50)	(0.49)	(0.16)	(0.49)	(0.48)	(0.15)
Net asset value, end of year	$4.47	$ 4.88	$4.46	$4.46	$4.88	$4.45
Total return fn **	1.84%	20.40%	15.50%	1.43%	19.90%	15.00%
Percentages and supplemental data:						
Net assets, end of period (000s)	$15,090	$14,167	$ 9,167	$ 3,772	$ 3,625	$ 2,292
Ratios to average net assets:						
Expenses fn ††	1.23%	1.30%	1.35% fn ‡‡	1.48%	2.05%	2.10% fn ‡‡
Net investment income fn ††	4.15%	2.82%	4.00% fn ‡‡	3.90%	2.07%	3.25% fn ‡‡
Portfolio turnover rate	92%	80%	75%	92%	80%	75%

The accompanying notes are an integral part of these financial statements.

Exhibit 5-4

ABC Feeder Fund, Inc.
Statement of Assets and Liabilities
December 31, 20X4

Assets	
Investment in ABC Master Portfolio	$ 15,089,600
Receivable for capital stock sold	110,000
Prepaid expenses and other assets	35,000
Total assets	15,234,600
Liabilities	
Administrative fee payable	20,000
Payable for capital stock redeemed	30,000
Dividends payable	40,000
Other accrued liabilities	25,000
Total liabilities	115,000
Net assets	$ 15,119,600
Net assets consist of:	
Paid-in capital, 1,250,000 shares outstanding	$ 12,258,600
Distributable earnings	2,861,000
Total net assets	$ 15,119,600
Net asset value per share	$12.10
Public offering price ($12.10 net asset value divided by 0.95)	$12.74

The accompanying notes are an integral part of these financial statements.

ABC Feeder Fund, Inc.
Statement of Operations fn ||
Year Ended December 31, 20X4

Net investment income allocated from ABC Master Portfolio:	
Dividends	$ 579,000
Interest	168,200
Income from loaned securities—net	40,000
Expenses fn ##	(179,000)
Net investment income from ABC Master Portfolio	608,200
Fund expenses:	
Administrative fees	15,000
Distribution and servicing fees	37,500
Professional fees	12,000
Transfer agent fees	35,000

Directors' fees	10,000
Registration fees	26,000
Other expenses	12,000
Total expenses	147,500
Investment income—net	460,700
Realized and unrealized gain (loss) on investments allocated from ABC Master Portfolio:	
Net realized gain on investments	865,000
Net change in unrealized appreciation (depreciation) on investments	(1,320,000)
Net loss on investments	(455,000)
Net increase in net assets resulting from operations	$ 5,700

The accompanying notes are an integral part of these financial statements.

ABC Feeder Fund, Inc.
Statements of Changes in Net Assets
Years Ended December 31, 20X4 and 20X3

	20X4	*20X3*
Increase (decrease) in net assets from operations:		
Investment income—net	$ 460,700	$ 369,000
Net realized gain on investments	865,000	750,000
Change in unrealized appreciation or depreciation	(1,320,000)	1,178,000
Net increase in net assets resulting from operations	5,700	2,297,000
Distributions to shareholders	(1,178,700)	(1,071,000)
Net increase from capital share transactions:		
Sold 147,000 and 207,000 shares	1,782,600	2,359,000
Distributions reinvested of 72,000 and 73,000 shares	880,000	820,000
Redeemed 20,700 and 13,000 shares	(250,000)	(150,000)
Net increase from capital share transactions	2,412,600	3,029,000
Total increase in net assets	1,239,600	4,255,000
Net assets: Beginning of year	13,880,000	9,625,000
End of year	$ 15,119,600	$13,880,000

The accompanying notes are an integral part of these financial statements.

ABC Feeder Fund, Inc.
Notes to Financial Statements

[*The following notes are limited to illustrations of disclosures unique to feeder fund financial statements. Besides the disclosures presented below, notes for a feeder fund would include all standard disclosures presented as part of the illustrative financial statements in chapter 7. Exceptions to the standard chapter 7 disclosures would be the omission of notes relating to the master fund portfolio activity and expenses such as the advisory fee incurred, which are disclosed in the master fund financial statements.*]

1. Significant Accounting Policies

ABC Feeder Fund, Inc. (the fund) is registered under the Investment Company Act of 1940 as a diversified, open-end management investment company. The fund invests substantially all of its assets in the ABC Master Portfolio, an open-end investment company that has the same investment objectives as the fund. The financial statements of the ABC Master Portfolio, including the schedule of investments, are included elsewhere in this report and should be read with the fund's financial statements. The percentage of ABC Master Portfolio owned by the fund at December 31, 20X4, was 80 percent.

Valuation of investments. The fund records its investment in ABC Master Portfolio at fair value. Valuation of securities held by ABC Master Portfolio is discussed in the notes to the ABC Master Portfolio financial statements included elsewhere in this report.

Investment income and expenses. The fund records daily its proportionate share of the ABC Master Portfolio's income, expenses, and realized and unrealized gains and losses. In addition, the fund accrues its own expenses.

ABC Feeder Fund, Inc.
Financial Highlights

	20X4	*20X3*	*20X2* fn ***
Per share operating performance: fn # fn †††			
Net asset value, beginning of year	$13.11	$11.75	$10.00
Income from investment operations:			
Net investment income	0.40	0.41	0.38
Net realized and unrealized gain (loss) on investment transactions	(0.39)	2.12	2.47
Total from investment operations	0.01	2.53	2.85
Less distributions	(1.02)	(1.17)	(1.10)
Net asset value, end of year	$12.10	$13.11	$11.75
Total return	0.08%	21.53%	28.50%
Percentages and supplemental data:			
Net assets, end of period (000s)	$15,119	$13,880	$9,625
Ratios to average net assets: fn †††			
Expenses	2.25%	2.30%	2.32% fn ‡‡
Net investment income	3.21%	2.48%	2.58% fn ‡‡

The accompanying notes are an integral part of these financial statements.

Exhibit 5-5

ABC Master Portfolio
Statement of Assets and Liabilities
December 31, 20X4

Assets	
Investments in securities, at fair value, identified	$ 21,101,000

cost $18,674,000	
Cash	199,000
Deposits with brokers for securities sold short	1,555,000
Collateral for securities loaned, at fair value	620,000
Receivables:	
Dividends and interest	100,000
Investment securities sold	24,000
Other assets	26,000
Total assets	23,625,000
Liabilities	
Options written, at fair value (premiums received $110,000)	230,000
Securities sold short, at fair value (proceeds $1,555,000)	1,673,000
Demand loan payable to bank	2,000,000
Payable upon return of securities loaned	620,000
Due to broker—variation margin	10,000
Payables:	
Investment securities purchased	210,000
Other	12,000
Accrued expenses	8,000
Total liabilities	4,763,000
Net assets	$18,862,000

The accompanying notes are an integral part of these financial statements.

ABC Master Portfolio
Statement of Operations
Year Ended December 31, 20X4

Investment income:	
Dividends (net of foreign withholding taxes of $20,000)	$ 742,000
Interest	209,000
Income from loaned securities—net	50,000
Total income	1,001,000
Expenses:	
Investment advisory fee	171,900
Interest	10,000
Professional fees	18,000
Custodian	13,100
Directors' fees	10,000
Dividends on securities sold short	3,000
Total expenses	226,000
Investment income—net	775,000
Realized and unrealized gain (loss) on investments:	
Net realized gain (loss) on investments	1,089,000
Net change in unrealized appreciation (depreciation) on investments	(1,649,000)
Net loss on investments	(560,000)
Net increase in net assets resulting from operations	$ 215,000

The accompanying notes are an integral part of these financial statements.

ABC Master Portfolio

Statements of Changes in Net Assets
Year Ended December 31, 20X4 and 20X3

	20X4	*20X3*
Increase (decrease) in net assets from operations:		
Investment income—net	$ 775,00	$ 492,000
Net realized gain on investments	1,089,000	1,000,000
Change in unrealized appreciation or (depreciation)	(1,649,000)	1,551,000
Net increase in net assets resulting from operations	215,000	3,043,000
Proceeds from contributions	3,000,000	5,000,000
Fair value of withdrawals	(2,145,000)	(2,751,000)
	855,000	2,249,000
Increase in net assets	1,070,000	5,292,000
Net assets:		
Beginning of year	17,792,000	12,500,000
End of year	$18,862,000	$17,792,000

The accompanying notes are an integral part of these financial statements.

ABC Master Portfolio
Notes to Financial Statements

[The following notes are limited to illustrations of disclosures unique to master fund financial statements. Besides the disclosures presented below, notes for a master fund would include all standard disclosures presented as part of the illustrative financial statements in chapter 7. Exceptions to the standard chapter 7 disclosures would be the omission of notes regarding dividend distributions, capital share transactions, and distribution fees, each of which is disclosed in the financial statements of the feeder fund.]

1. Significant Accounting Policies

ABC Master Portfolio (the portfolio) is organized as a trust and is registered under the Investment Company Act of 1940 as a diversified, open-end management investment company. The Declaration of Trust permits the trustees to issue nontransferable interests in the portfolio. For federal income tax purposes, the portfolio qualifies as a partnership, and each investor in the portfolio is treated as the owner of its proportionate share of the net assets, income, expenses, and realized and unrealized gains and losses of the portfolio. Accordingly, as a pass-through entity, the portfolio pays no income dividends or capital gain distributions.

2. Federal Income Taxes

The portfolio will be treated as a partnership for federal income tax purposes. As such, each investor in the portfolio will be subject to taxation on its share of the portfolio's ordinary income and capital gains. It is intended that the portfolio's assets will be managed so an investor in the portfolio can satisfy the requirements

of Subchapter M of the Internal Revenue Code.

3. Financial Highlights

Financial highlights for the portfolio for each period were as follows:

	20X4	*20X3*	*20X2* fn ‡‡‡
Total return	1.21%	24.34%	31.20%
Ratios to average net assets:			
Expenses	1.23%	1.25%	1.27% fn ‡‡
Net investment income	4.23%	3.25%	3.34% fn ‡‡
Portfolio turnover rate	92%	80%	102%

Exhibit 5-6

FOF Fund, Inc.
Statement of Net Assets
September 30, 200Y

[The following sample financial statements are limited to matters directly related to funds of funds. The sample financial statements in chapters 5 and 7 should be consulted for relevant disclosures.]

Assets:	
204,100 shares FOF Growth Fund, Inc.	$2,046,762
182,633 shares FOF International Fund, Inc.	2,224,470
96,152 shares FOF Income Fund, Inc.	1,046,134
602,908 shares FOF Money Market Fund, Inc.	602,908
Total investments (cost $5,617,279)	5,920,274
Cash	9,000
Receivable for Fund shares sold	23,652
Other assets	2,710
Total assets	5,955,636
Liabilities:	
Payable for Fund shares repurchased	37,123
Accrued expenses	8,327
Total liabilities	45,450
Net assets (equivalent to $10.73 per share based on 550,810 shares of capital stock issued and outstanding; unlimited shares authorized)	$5,910,186
Components of net assets:	
Paid-in capital	$5,569,426
Distributable earnings	340,760
	$5,910,186

The accompanying notes are an integral part of these financial statements.

FOF Fund, Inc.
Statement of Operations
Year Ended September 30, 200Y

Investment income:	
Dividends from investment company shares	$201,942
Expenses:	

Custodian and transfer agent fees	$22,560	
Professional fees	8,318	
Registration fees	1,040	
Directors' fees	1,982	
Total expenses		33,900
Net investment income		168,042
Realized and unrealized gain (loss) on investments:		
Realized gain on sales of investment company shares	$12,067	
Realized gain distributions from investment company shares	321,939	
Net realized gain		334,006
Change in unrealized appreciation (depreciation) on investments during the year		219,837
Net realized and unrealized gain		553,843
Net increase in net assets resulting from operations		$721,885

The accompanying notes are an integral part of these financial statements.

FOF Fund, Inc.
Statements of Changes in Net Assets
Years Ended September 30, 200Y and 200X fn

	200Y	*200X*
Increase (decrease) in net assets from:		
Net investment income	$168,042	$32,177
Net realized gain on investments	334,006	16,090
Change in net unrealized appreciation	219,837	83,158
	721,885	131,425
Distributions to shareholders	(484,617)	(27,933)
Capital share transactions—net	2,172,589	3,396,837
Net increase in net assets	2,409,857	3,500,329
Net assets:		
Beginning of year	3,500,329	—
End of year	$5,910,186	$3,500,329

The accompanying notes are an integral part of these financial statements.

FOF Fund, Inc.
Notes to Financial Statements

1. Significant Accounting Policies

FOF Fund, Inc. (the fund) is registered under the Investment Company Act of 1940, as amended, as a diversified, open-end management investment company. The fund invests solely in shares of other funds within the FOF Group of Mutual Funds with the objective of seeking high total return through investments allocated to diverse equity and fixed-income markets.

The following is a summary of significant accounting policies that are in conformity with generally accepted accounting principles and which are followed

consistently by the fund in the preparation of its financial statements. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts and disclosures in the financial statements. Actual results could differ from those estimates.

Security Valuation. Investments in funds within the FOF Group of Mutual Funds are valued at their net asset value as reported by the underlying funds.

Transaction Dates. Share transactions are recorded on the trade date. Dividend income and realized gain distributions from other funds are recognized on the ex-dividend date. Distributions to shareholders, which are determined in accordance with income tax regulations, are similarly recorded on the ex-dividend date. In determining the net gain or loss on securities sold, the cost of securities is determined on the identified cost basis.

Federal Income Taxes. The fund's policy is to comply with the requirements of the Internal Revenue Code applicable to regulated investment companies and to distribute all of its taxable income to its shareholders. Thus, no federal income tax provision is required.

2. Investment Transactions

Cost of purchases and proceeds of sales of shares of funds within the FOF Group of Mutual Funds (excluding FOF Money Market Fund, Inc.) for the year ended September 30, 200Y, were $2,482,315 and $336,232, respectively. At September 30, 200Y, the cost of investments for federal income tax purposes was $5,617,279 and gross unrealized appreciation was $302,995; there was no gross unrealized depreciation.

3. Investment Advisory Services and Other Transactions With Affiliates

The fund receives investment management and advisory services, consisting principally of determining the allocation of the assets of the fund among designated underlying funds, under a management agreement with FOF Investment Management, Inc. (the manager). The manager receives no compensation under this agreement; however, the fund pays management fees and expenses to the manager indirectly, as a shareholder in funds of the FOF Group of Mutual Funds. Additionally, each fund in which the fund invests (except FOF Money Market Fund, Inc.) pays a distribution fee to FOF Distributors, Inc., the distributor of the fund, in the amount of 0.25 percent of average annual net assets. The fund pays no sales loads or similar compensation to FOF Distributors, Inc. to acquire shares of each fund in which it invests.

Because the underlying funds have varied expense and fee levels and the fund may own different proportions of underlying funds at different times, the amount of fees and expenses incurred indirectly by the fund will vary.

The fund paid $1,982 to unaffiliated directors during the year ended September 30, 200Y. No compensation is paid to any director or officer who is affiliated with the manager.

4. Capital Share Transactions

Transactions in capital shares were as follows:

	Years Ended September 30,			
	200Y		*200X*	
	Shares	*Amount*	*Shares*	*Amount*
Shares sold	204,017	$2,077,520	354,695	$3,590,241
Shares issued in reinvestment of dividends	41,817	425,255	2,615	27,013
Shares redeemed	(30,948)	(330,186)	(21,386)	(220,417)
Net increase	214,886	$2,172,589	335,924	$3,396,837

5. Components of Capital

Components of capital on a federal income tax basis at September 30, 200Y, were as follows:

Paid-in capital	$ 5,569,426
Undistributed net investment income	11,460
Undistributed net realized gain	26,305
Unrealized appreciation	302,995
	$ 5,910,186

The tax character of distributions paid during the years ended September 30, 200Y, and 200X, was as follows:

	200Y	*200X*
Ordinary income	$160,826	$27,933
Long-term capital gain	323,791	—
	$484,617	$27,933

Financial Highlights

	Year Ended September 30,	
	20X4	*20X3*
Per share data (for a share outstanding throughout the period):		
Net investment income fn ###	$ .38	$ .20
Net realized and unrealized (gain) loss on investments	1.04	.38
Total from investment operations	1.42	.58
Less: Distributions to shareholders	(1.11)	(.16)
Net increase (decrease)	.31	.42

Net asset value:		
Beginning of year fn ****	10.42	10.00
End of year	$10.73	$10.42
Total return	13.59%	5.86%
Net assets, end of year (000s)	$5,910	$3,501
Ratio of expenses to average net assets fn ††††	0.72%	0.89% fn ‡‡
Net investment income as a percentage of average net assets fn ###	3.59%	1.96% fn ‡‡
Portfolio turnover rate	21%	5%

Chapter 6

Taxes

Overview

6.01 This chapter provides information on the Internal Revenue Code of 1986, *as amended* (IRC). Its intended purpose is to provide auditors with background information; however, it is not intended as a detailed explanation of the IRC. Thus, the auditor should consult a tax adviser with respect to tax issues that arise in the course of an audit. Auditors may not be able to resolve tax issues that arise in the course of an audit based solely on the background information provided in this chapter.

6.02 This chapter has been divided into two sections to focus on distinct aspects of taxes for investment companies: "Financial Statements and Other Matters" and "Taxation of Regulated Investment Companies." Due to the extensive interrelationships between taxes and the underlying accounts or products, certain tax matters appear in other chapters, as follows:

Topic	*Paragraph Reference*
Dividends to shareholders and reinvestments	4.45
Characterization of dividends for financial statement purposes	7.39
Financial statement disclosures:	
—Status under Subchapter M	7.77
—Capital loss carryforwards and post-October capital and currency loss deferrals	7.77
Multiple classes of shares:	
—Preferential dividends	5.10, 5.14
—Return of capital	5.17